ST 02-0005-GIL 01/09/2002 MICELLANEOUS

This letter discusses the Retailers' Occupation Tax Act, Service Occupation Tax Act, and Use Tax Act and their application to several transactional hypotheticals.

January 9, 2002

Dear Xxxxx:

This letter is in response to your letter dated February 22, 2001. The nature of your letter and the information you have provided require that we respond with a General Information Letter, which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. See, 2 Ill. Adm. Code 1200.120 subsections (b) and (c), which can be found at http://www.revenue.state.il.us/legalinformation/regs/part1200.

In your letter, you have stated and made inquiry as follows:

This is to request a letter ruling regarding the taxability of certain AAA sales to customers who are reselling our products to their customers in your State.

We request advice regarding the taxability of third-party drop shipments made by AAA into your State on behalf of resellers claiming to have no presence or nexus and are not registered or licensed to collect tax in your State. It has come to our attention that you have investigated this issue and responded to survey questions posed by the BBB. Based on the information provided in their publication, the State will accept a resale certificate or a similar document from our customers for sales of tangible personal property even if our customer is not a registered taxpayer within your State. However, we have questions regarding the taxability of transactions between AAA and its customers that involve the sale for resale of services within your State.

Facts:

AAA is a manufacturer of computer equipment, software, printers and related supplies. AAA also sells various computer related repair services on a per-incident or contractual basis. We also sell optional software support agreements providing software users phone-in support capabilities and access to software updates, if any.

AAA is registered in your State to collect sales and/or use taxes. We sell our products to both end-users and resellers.

For the purpose of this request, our customer is a retailer of computer goods and software solutions. Our customer claims to have no presence or nexus in your State and is not registered to collect sales and use taxes in your State.

An end-user located in your State contracts with the retailer, our customer, for the purchase of certain computer equipment and related software applications. Our reseller customer contracts with AAA to purchase and resell AAA manufactured computers and software applications AAA has developed.

Our reseller customer requests that AAA ship the computer products directly from our manufacturing site, which is located outside of your State, to their customer in your State. The products are shipped via common carrier.

Our customer has provided AAA with a valid resale exemption certificate for their **home** State.

Questions:

1. Given that our reseller customer is neither registered in nor has nexus with your State, will you recognize AAA's sales as a tax exempt sale for resale? *(Yes or No)*

> If yes, what documentation must AAA retain from our customer to support this exempt sale for resale? As stated above, our reseller customers cannot provide a valid resale certificate from your State.
>
> If no, would the answer be different if the end-user in your State is exempt from sales tax (e.g. government agencies, non-profit organizations, etc…)?

2. If given the facts cited below, how will the taxability of these transactions change for AAA?

> a. The end-user customer in your State purchases from our reseller customer an optional hardware maintenance agreement. Our reseller customer contracts with AAA to provide these services to their customer and the services are performed by AAA employees or AAA contractors at the end-users site in your State.
>
> b. The end-user customer in your State purchases the same hardware maintenance agreement, but rather than having technicians come to their site, the products are shipped to AAA outside of your State for service or repair.

3. Without regard to question 2, if given the facts cited below, how will the taxability of these transactions change for AAA?

> The end-user in your State purchases from our reseller customer an optional software support agreement which provides technical software consulting services and access to software application updates in the event they are released during the contract period. Our reseller customer contracts with AAA for the delivery of these services; however, our technical software consulting service is provided via telephone by an AAA software expert located in another State. Any software updates or manuals are shipped from an AAA site located outside of your State to the end-user customer in your State.

4. Without regard to question 2 or 3, if given the facts cited below, how will the taxability of these transactions change for AAA?

AAA not only ships the products to the end-user, but also sends an AAA employee or AAA contractor to install the computer equipment and software at the end-users site in your State?

5. Lastly, if AAA is required to charge sales and/or use tax on any of these types of transactions, what base is to be used to calculate the tax? Please keep in mind that AAA has no knowledge of the purchase price paid by the end-user customer in your State for any products or services sold through a third party.

For each of your responses, please provide the State statute or regulation reference upon which your response is based.

We thank you in advance for your response to this request for a letter ruling. Should you have any questions regarding the facts or questions, please contact me directly.

Question 1:

Illinois will not recognize AAA's sales of tangible personal property as tax-exempt sales for resale unless the reseller customer can provide you with proper documentation. You appear to have described a drop shipment situation in Question 1. See 86 Ill. Adm. Code 130.225.

A drop-shipment situation is one in which out-of-State purchasers make purchases for resale from companies that are registered with Illinois and have those companies drop-ship the property to purchaser's customers located within the State of Illinois. For this discussion, it is assumed that purchasers are out-of-State companies that are not registered with the State of Illinois and do not have sufficient nexus with Illinois to require them to collect Illinois Use Tax.

As sellers required to collect Illinois tax, companies must either charge tax or document exemptions when they make deliveries in Illinois. In order to document the fact that their sales to purchasers are sales for resale, companies are obligated by Illinois to obtain valid Certificates of Resale from Purchasers. See 86 Ill. Adm. Code 130.1405.

If purchasers have no nexus with Illinois, it is unlikely that purchasers would be registered with Illinois. If that is the case, and if the purchasers have no contact with Illinois which would require them to be registered as out-of-State Use Tax collectors for Illinois, then the purchasers can obtain resale numbers which would provide them the wherewithal to supply required numbers to companies in conjunction with Certificates of Resale.

The fact that purchasers may not be required to act as Use Tax collectors for Illinois does not relieve their customers of Use Tax liability. Therefore, if purchasers do not collect Illinois Use tax from their customers, the customers would have to pay their tax liability directly to the Illinois Department of Revenue.

While active registration or resale numbers on Certificates of Resale are still preferred, the Illinois Retailers' Occupation Tax Act provides that failure to present an active registration number or resale number and a certification to the seller that a sale is for resale creates a presumption that a sale is not for resale. This presumption may be rebutted by other evidence that all of the seller's sales are sales for resale or that a particular sale is a sale for resale [35 ILCS 120/2c]. In light of this statutory language, certifications from purchasers on Certificates of Resale in lieu of resale numbers that described the drop-shipment situation and the fact that purchasers have no contact with Illinois that would require them to be registered and that they choose not to obtain Illinois resale numbers would

constitute evidence that this particular sale is a sale for resale despite the fact that no registration number or resale number is provided. The risk run by companies in accepting such a certification and the risk run by purchasers in providing such a certification is that an Illinois auditor is much more likely to go behind a Certificate of Resale that does not contain a valid resale number and require that more information be provided by companies as evidence that the particular sale was, in fact, a sale for resale.

Question 2:

The taxability of maintenance agreements depends upon if the charges for the agreements are included in the selling price of the tangible personal property. If the charges for the agreements are included in the price of the tangible personal property, those charges are part of the gross receipts of the retail transaction and are subject to tax. No tax is incurred on the maintenance services or parts when the repair or servicing is performed.

If maintenance agreements are sold separately from tangible personal property, sales of the agreements are not taxable transactions. However, when tangible personal property is transferred by a service provider incident to the completion of a maintenance agreement, Section 2 of the Service Occupation Tax Act provides that this transaction is exempt from Service Occupation Tax. See, 35 ILCS 115/2. However, the provisions of Section 3-75 of the Use Tax Act provide that tangible personal property purchased by a serviceman is subject to Use Tax when purchased for transfer by the serviceman incidental to completion of a maintenance agreement. See, 35 ILCS 105/3-75. See also the provisions of Section 140.301 (b)(3). That regulation states that when a service provider enters into an agreement with his customer to provide maintenance services for particular pieces of equipment for stated periods of time at predetermined fees, the service provider selling the maintenance agreement incurs Use Tax (see 35 ILCS 105/1 et seq.) based on his cost price of the tangible personal property transferred to customers incident to completion of the maintenance service.

In the first situation you have described (2.a), the service provider selling the agreement farms out maintenance contract work to AAA, who performs that work in the State of Illinois. Your customer, the service provider, incurs a Use Tax liability on its cost price of the parts transferred incident to completion of the maintenance agreement, as explained above. Since AAA has sufficient nexus with Illinois to act as a Use Tax collector, it is required to collect the Use Tax from its customer. Your customer's (i.e., the service provider that sold the maintenance agreement) cost price of the tangible personal property transferred incident to completion of the maintenance agreement is presumed to be equal to 50% of your charges to him, in the absence of proof of the consideration paid by you for such property.

In the second situation you have described (2.b), the result is different because the tangible personal property transferred incident to service by AAA is not transferred in the State of Illinois. No use of that property occurs in Illinois, as it does in the first example, in which AAA transfers tangible personal property in Illinois incident to completion of the maintenance agreement.

Question 3:

You have described a sale of a software maintenance agreement in question 3. Generally, software maintenance agreements are taxed in the same manner as other maintenance agreements (see above discussion and Section 130.1935 (b)). However, as Section 130.1935 (b) states, charges for updates of canned software are considered to be sales of software subject to tax. If a maintenance agreement provides for updates of canned software, and the charges for those updates are not

separately stated and taxed, then the whole agreement is considered to be taxable as a sale of canned software. If canned software is transferred as part of the maintenance agreement, it would be subject to tax (depending upon how it is stated) as explained immediately above. In this case, you would be considered to be making sales of software to your reseller customer. Your reseller customer would have to provide you with proper documentation that its purchase is made for resale, as explained in the discussion of drop shipments above, in order for the sale to be made tax-free.

Question 4:

We must make several assumptions in order to answer this question. First, we assume that you have asked about the sale of tangible personal property (computer software and hardware). Charges for installation of software are exempt if they are separately stated from the selling price of canned software. Installation charges for the hardware are subject to tax if they are included in the selling price of the tangible personal property sold. However, if the purchaser signs an itemized invoice so as to make the installation charges the subject of a separate agreement, the installation charges are not subject to tax. See the provisions of Section 130.450 (a). The remainder of your question is answered by the same principles articulated in our discussion of Question 1.

Question 5:

It appears, based upon our understanding of the facts presented in your letter, that you would be required to collect Use Tax on the transactions you have described. This tax is more fully described at 86 Ill. Adm. Code 150.105, see enclosed copy. The rate of the Use Tax is 6.25% of the selling price of the tangible personal property sold at retail. If your reseller customer cannot document the resale exemption, for example, you must collect tax on 6.25% of your selling price to that customer. Please refer to the response to Question 2 for an explanation of the tax collected when you perform maintenance contract work for a service provider.

I hope this information is helpful. The Department of Revenue maintains a Web site, which can be accessed at www.revenue.state.il.us. If you have further questions related to the Illinois sales tax laws, please contact the Department's Taxpayer Information Division at (217) 782-3336.

If you are not under audit and you wish to obtain a binding Private Letter Ruling regarding your factual situation, please submit all of the information set out in items 1 through 8 of Section 1200.110(b).

Very truly yours,

Jerilynn Gorden
Senior Counsel – Sales and Excise Taxes

JTG:msk
Enc.